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RUEAIIA/CIA WASHDC
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C O N F I D E N T I A L SECTION 01 OF 02 MANAGUA 001381

SIPDIS

STATE FOR WHA/CEN, WHA/EPSC AND EEB
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TAGS: ECON EFIN ELAB ETRD NU PGOV PREL
SUBJECT: NICARAGUA: INFLATION: A GATHERING STORM

REF: A. (A) MANAGUA 1213
¶B. (B) MANAGUA 1157

Classified By: Amb. Robert J. Callahan for Reasons 1.4 b & d.

¶1. (C) Summary. The rate of inflation in Nicaragua is the highest in Central America and the second-highest in Latin America. High petroleum and food prices, and off-budget cash inflows from Venezuela appear to be the main causes. The steep rise in food prices disproportionately affects the poorest in Nicaraguan society. President Daniel Ortega has raised the minimum wage three times since assuming the presidency, rendering the country,s apparel sector less competitive in global markets (Ref A) and likely contributing to inflationary pressures. One problem from a monetary policy point of view is that the country,s crawling peg exchange rate has not kept pace with inflation, resulting in a stronger cordoba. An abrupt devaluation of the cordoba in the future would result in higher prices for imports, especially for food. End Summary.

PRICES CONTINUE TO CLIMB

¶2. (C) According to the Central Bank of Nicaragua, accumulated annual inflation for 2008 is forecast to be 18%. The rate of inflation in 2007 was 17%, which means that by the end of this calendar year Nicaraguans will have experienced an approximately 35% increase in prices over the last two years. While August registered the lowest monthly inflation rate in two years as a result of the sudden worldwide decrease in petroleum prices, other inflationary pressures persist. Nicaragua,s rate of inflation is second-highest in Latin America after Venezuela.

¶3. (U) Prices of items in the basic market basket of goods have risen by more than 25% so far in 2008. The dramatic increase in food prices (especially for rice, beans, and corn) disproportionately affects the poor: 20% of the country,s poorest households spend as much as 80% of their income on food, making them vulnerable to high prices for staples. Transportation prices also have risen as a result of the international price of petroleum, although there has been some relief recently. The steep rise in food and transportation prices motivated President Ortega to increase minimum wages for laborers in key sectors such as manufacturing, not coincidentally an important political base for the Sandinista National Liberation Front (FSLN). Since taking office in January 2007, Ortega has increased minimum wages by 60%; the last time was an 18% hike on October 1 (Ref

A). While helping to mitigate the effects of inflation on the working class, these wage increases may be contributing to an inflationary spiral.

¶4. (U) To partially offset internal and external inflationary pressures, the Central Bank has pursued a strong cordoba policy, maintaining a controlled 5% per year devaluation against the dollar through a crawling peg mechanism--even as the differential between the Nicaraguan and U.S. inflation rate would support a devaluation more than twice this rate. The strong cordoba policy has reduced the cordoba cost of importing beans and rice, as well as fuel.

VENEZUELAN CASH, A HIDDEN INFLATIONARY CATALYST

¶5. (C) Substantial Venezuelan assistance, most of which is off-budget, may be contributing to inflation, but no one knows how much. In September 2008, the Central Bank of Nicaragua (BCN) published a report detailing in rudimentary terms Venezuelan assistance to Nicaragua in 2007 (Ref B). According to the report, Venezuela provided $185 million in official assistance to Nicaragua in 2007. In May 2008, however, President Ortega declared that official Venezuelan assistance totaled $520 million, nearly three times the 2007 figure stated in the BCN report. Either amount of Venezuelan cash moving through a small economy such as Nicaragua,s (2007 GDP $5.7 billion) would likely contribute to inflation.

EXPORTERS AND CURRENCY EXPOSED

¶6. (U) One problem, from a monetary policy point of view, is that the dollar exchange rate for the cordoba has not kept pace with inflation. Despite an inflation differential with the United States of around 15% for two years running, the Central Bank has continued to depreciate the cordoba at an annual rate of 5%. The cordoba,s relative strength vis-a-vis the dollar is hurting local businesses which export to the United States. To counter pressures to devalue faster, the Central Bank had to increase its reserves, but at some cost to the economy. While this strategy has allowed the country to import food and fuel at less expensive prices, inflationary pressures on the overvalued cordoba are mounting. Remittances from the United States partially mitigate this pressure, but are expected to decrease in the near future as a consequence of the global financial crisis. As of November 6 the exchange rate was officially 19.70 cordobas per dollar.

COMMENT

¶7. (C) The GON cannot afford to ignore the creeping effects of inflation. The apparel sector (which supports 75,000 jobs) is suffering from the latest round of wage hikes and a declining U.S. market. For the first time, garment companies in Nicaragua have started relocating to more competitive labor markets in East Asia. Moreover, an abrupt adjustment of the crawling peg exchange rate would result in a sudden price increase for imported goods such as rice, fuel and certain foodstuffs that many Nicaraguans rely on to meet their basic needs. Thus, the FSLN ignores inflation trends at its own peril.
CALLAHAN